Index Mishmash – Commentary August 2021

To the end of August South Africa is on par with the MSCI World in USD terms and still far ahead of Emerging Markets. Within Developed Markets the US continues to lead. The Nasdaq is in line with the S&P 500, as are the Value and Growth indices. These various market returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for August 2021*

	Aug-21	YTD 2021
FTSE/JSE ALSI (ZAR)	-1.7%	15.9%
FTSE/JSE ALSI (USD)	-0.6%	17.7%
MSCI World	2.5%	17.9%
MSCI EM	2.6%	2.8%
MSCI Value	1.6%	17.3%
MSCI Growth	3.3%	18.2%
S&P 500	3.0%	21.2%
Nasdaq 100	4.3%	21.5%

*Total return indices, Source: Factset

This month we consider the various broad equity indices available in South Africa and some of the challenges benchmarking presents. An equity market index should reflect the substance of companies available to invest in. In South Africa the reference index has been the All-Share Index (ALSI), while the Shareholder-Weighted Index, or the SWIX, was introduced subsequently. This was then followed by the Capped SWIX. The performance of the Average Equity Fund, as a peer group benchmark, is also frequently used in benchmarking.

These various indices attempt to address different aspects of benchmarking including

- availability of underlying assets
- how representative a benchmark is of a market
- possible concentration of underlying assets
- index performance

Each index, however, has strengths and weaknesses.

Availability of assets – how relevant is the free float?

Start with availability. The market indices in South Africa underwent a transformation to free float in the early 2000s in line with global indices i.e. the ALSI today only includes shares which are actively traded and are not part of some sort of "strategic" shareholding. This issue is not widely debated anymore, however one could still raise some points of interest

- from an international perspective, why, for example, exclude Jeff Bezos's shareholding in Amazon? This stake has been material to company's performance. Bezos has also reportedly been selling close to USD 1 billion per annum to fund his space ventures. This necessitates frequent recalculation and adjustment to the indices' free float. Does it really represent a non-traded stake? It would seem that what is deemed to be "strategic" could turn out, under closer examination, to be somewhat arbitrary
- as a separate issue, in South Africa, as elsewhere, it happens to be the case that on average, companies with strategic shareholdings outperform, meaning the original non-free float indices were often harder to beat

Representativeness – shareholder weights

The requirement that an index should broadly reflect the availability of companies in a market has created some issues in South Africa. This concerns exchange controls and what the JSE refers to as "grandfathered" companies – primarily Anglo American and the BHP Group, along with a few others. Anglo and BHP have a collective weight of 21% in the ALSI. This dominance led to calls at the time for only those shares traded in South Africa, as opposed to those trading in London, to be included in a market index since anything else was not "representative". At the same time this would reduce these companies' weights in an index. Enter the SWIX – or the Shareholder-Weighted Index which includes only shares on the South African register. Anglo and BHP's combined weight in this index is only 6.7%.

Technically more representative, but also raises an issue

- BHP's weight in the SWIX is only 2.2%. Is the index genuinely representative if BHP is lower-weighted than Sibanye Stillwater (full market cap including Stillwater in Nevada, US), Impala Platinum, Standard Bank or MTN at approximately 2.6%, 3.0%, 3.0% and 4.0% each?

Incidentally, from a performance point of view - as demonstrated further below – the SWIX did not make much difference, anyway up to 2018 at least, since both indices' performance broadly matched from 2010 to 2018.

Concentration – the rise of Naspers

Somewhat inconveniently, Naspers, wholly-listed in South Africa, returned 72% in 2013 and 101% in 2017, and reached a weight of over 20% in the ALSI - more so in the SWIX since Anglo and BHP and otherwise higher-weighted but foreign-listed companies, such as Richemont, are restricted in the SWIX.

This "new" development led to the introduction of the Capped SWIX to limit concentration risk. Naspers, and now Prosus, are collectively restricted to 10% of the index, pending review. A relatively high exposure to a single company is considered insufficient diversification. True, after the fact. Prior to the fact, however, much like the calls to unbundle Tencent, both institutional and retail investors would not have felt disadvantaged by their Naspers returns. Looking forward, notwithstanding current regulation issues in China, what if Naspers/Prosus surprise on the upside? Investors benchmarked to the Capped SWIX could well miss out, as they have to date.

In addition to the above issues, more recently, as has been well-covered in the media, Naspers's performance has also led to various contortions by the company itself to reduce its weight in the SWIX.

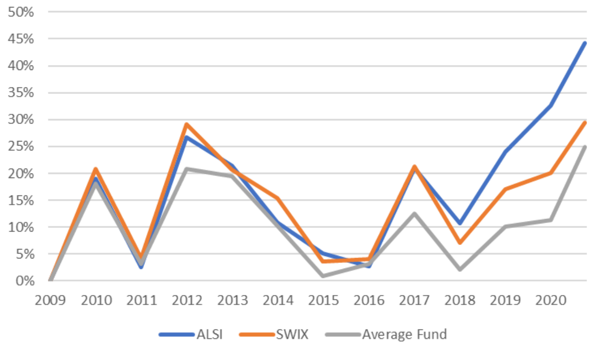
South Africa and Naspers/Prosus are, incidentally, not at all unique in terms of concentration internationally. Samsung-related companies in South Korea collectively account for 43% of the MSCI Korea Index. And Novo Nordisk in Denmark, a large, global pharmaceutical company known for its diabetes drugs, accounts for 35% of the MSCI Denmark. High concentration is, perhaps, simply a consequence of smaller markets having outsized successes in their companies. South Africa could certainly be considered fortunate when the rise of Naspers is viewed from this angle.

Performance

Performance is perhaps where the rubber really hits the road. Put simply, the ALSI has been the index hardest to beat. Chart 1 below sets out the ALSI's outperformance of the

SWIX and the Average Equity Fund for the 11+ year period from 2010 to 21 September 2021.

Chart 1. Cumulative performance of the ALSI, SWIX and the average equity fund*



*Total return indices

Source: Factset, Morningstar, Profile Data

In 2019 and 2020 the ALSI was powered by Naspers and mining companies' outperformance. In 2021 another company has proven dominant – Richemont – a global business, now accounting for 11% of the index after returning 22% for the year-to-date.

The Capped SWIX in the meantime, introduced in 2016, has not been terribly inspiring, to date at least. Table 1 below sets out the price returns of the ALSI, SWIX and the Capped SWIX from end-2016 to 21 September 2021.

Table 1. Performance of the ALSI, SWIX and Capped SWIX - 31 Dec 2021 to 21 Sep 2021*

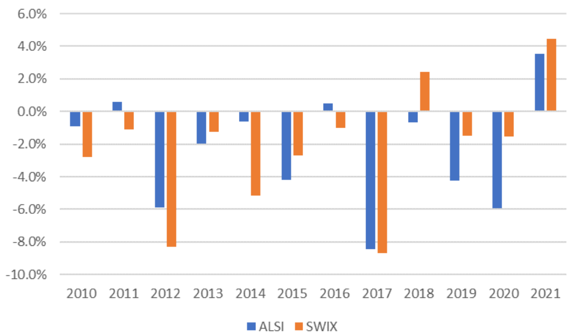
ALSI	23.1%
SWIX	11.9%
Capped SWIX	6.2%

*Price index returns

Source: Factset

Finally, we consider the performance of the Average Equity Fund, represented by the General Equity Average. Chart 2 below sets out the difference in annual performance of the General Equity Average to both the ALSI and the SWIX.

Chart 2. Difference in performance of the Average Equity Fund to the ALSI and the SWIX per annum



Source: Morningstar, Profile Data, M1 Capital

The Average Equity Fund has historically consistently underperformed both the ALSI and the SWIX, even after allowing for costs. The year-to-date 2021 appears to be possibly exceptional as both Resources and Naspers have underperformed, while shares strongly affected by the pandemic in 2020, Richemont included, rebound and outperform.

So which index?

There has been an apparent proliferation of benchmarks as each new index has been devised as a solution to a new problem that has emerged. Certainly, technical arguments are valid. Returns, however, still matter. It should also hardly be forgotten that the reason for the existing concentration in the ALSI - Naspers/Prosus, Anglo/BHP and Richemont now account for 41% of the index - is mostly due to the superior performance of these companies' securities.

M1 Capital has chosen to benchmark its South African equity fund to the ALSI because it remains the reference index, and because historically it has been the most demanding index to outperform. We view it as the asset manager's responsibility to overcome difficulties of concentration and present things as they are as opposed to moving the goalposts.